

# **Taxation of Duty-Related Disability Benefits**

## **Issue:**

The statutory structure of disability benefits for LEOFF Plan 2 does not allow members who become disabled in the line of duty to take advantage of federal law which makes those benefits wholly, or partially, nontaxable.

## **A. Background:**

### **Withdrawals:**

A LEOFF 2 member may request a refund of their accumulated contributions and interest any time after they separate from employment, regardless of the reason for the separation. A LEOFF 2 member with ten or more years of service is entitled to withdraw 150% of their accumulated account balance. The member's account balance includes member contributions and interest credited at the rate of 5.5% annually, compounded quarterly, as determined by the Director of the Department of Retirement Systems. The member's account balance does not include state or employer contributions.

### **Disability Retirement:**

A LEOFF 2 member who becomes totally incapacitated for continued LEOFF employment is eligible to receive a disability retirement benefit. The amount of the benefit is equal to 2% of the member's final average salary for each year of service actuarially reduced to reflect the difference between the member's age at the time of disablement and the normal retirement age of 53. A member may elect to withdraw their accumulated contributions in lieu of receiving a disability retirement.

### **Experience:**

There have been very few disability retirements since the inception of LEOFF Plan 2 in October 1977. Approximately 250 LEOFF 2 members a year withdraw their accumulated contributions. The number of members who withdraw their accumulated contributions following separation from employment due to a duty-related disability is not known.

## **B. Taxation of Duty Disability Benefits:**

### **IRS Requirements for Nontaxability:**

A service-connected disability benefit under a "statute in the nature of a workmen's compensation act" is nontaxable under Internal Revenue Code section 104(a)(1).

- The benefits can be provided under a retirement plan in addition to worker's compensation benefits. [Rev. Rul. 68-10, 1968-1 C.B. 50; Private Letter Ruling 9801007 (September 24, 1998)]

- In order to qualify, the benefits must apply only to service-connected disabilities. However, if the benefits are provided under different provisions of statute, even if the benefits are identical, benefits provided under the service-connected disability provision will qualify. [Rev. Rul. 85-104, 1985-2 C.B. 52; Rev. Rul. 74-582, 1974-2 C.B. 34]
- In order to qualify, the benefit cannot be based on employee contributions. However, member contributions to LEOFF 2 are subject to “pick-up” by employers and are not treated as employee contributions by the IRS. [Treas. Reg. 1.104-1]
- In order to qualify, the disability benefit must not be based on years of service or age. [Rev. Rul. 85-104, 1985-2 C.B. 52] Eligibility for the 150% withdrawal is currently limited to members who have ten years of service.
- If a service-connected disability provision provides a benefit based on age and/or years of service, subject to minimum which is not based on years of service, the benefit will be broken into two parts:
  1. Only the minimum benefit can qualify as a service-connected disability benefit [Rev. Rul. 85-104, 1985-2 C.B. 52]
  2. The remainder of the disability benefit is subject to the provisions for a non-service connected disability benefit.

**Analysis of current LEOFF 2 benefits:**

The LEOFF 2 disability retirement benefit is entirely based on both years of service and age so it is taxable under federal law. Every vested member is entitled to at least 10% of average final salary (5 years of service multiplied by 2% per year multiplied by average final salary). If a minimum duty-disability benefit for vested members of 10% of average final salary were established, that minimum benefit would meet the federal requirements to be considered nontaxable.

The LEOFF 2 150% withdrawal benefit would meet the federal requirements to be considered nontaxable if the ten-year service requirement were eliminated for members who separate from service due to a duty-related disability.

**Retroactivity:**

A person may amend their federal income tax return up to three years after filing. A retroactive statutory change could allow a LEOFF 2 member who withdrew their contributions following a duty-related disability in the past three years to re-file their tax return with a reduced taxable income and potentially receive a federal income tax refund.